

NYSE and the Specialists: Risk, Reward, Competition and Governance

Randall S. Kroszner

University of Chicago and AEI

October 8, 2003

randy.kroszner@gsb.uchicago.edu

Becker:

Based on publicly available data, NYSE trading specialists earn higher operating profit levels than market makers outside of the NYSE.

Pre-Tax Profit/Revenue Comparison

- Average for NYSE Specialists: 47.5%
- Security Brokers, Dealers, & Flotation Companies: 9.7%
- NASDAQ, Inc: 12.5%
- Other comparable companies or industry categories: negative to 28.4%

Three Issues of Interpretation and Policy:

- Risk – What is correct benchmark for evaluating whether profits are “excessive”?
- Competition – What are the benefits relative to the costs of increasing the competitiveness of these markets?
- Governance – What is the best governance structure to ensure that interests are appropriately balanced?

1) Risk Factors

- When evaluating the profitability, must consider both reward *and* risk.
- A one year snapshot may not capture the riskiness of the income stream.
 - Volatility of stocks
 - Correlation with market movements (e.g., Beta)
 - Other risks, e.g., extreme events such as 1987 or 9/11

Role of Specialists

- Must “maintain a fair, competitive, orderly, and efficient market” (NYSE)
- Auctioneer
- Agent (e.g., Superdot electronic trades)
- Principal

Risk/Burdens of Specialists vs. Risk/Burdens of Others

- Specialists are required to “use their capital to bridge temporary gaps in supply and demand and help reduce price volatility by cushioning price movement” (NYSE).
- Did the specialists provide more support in the 1987 Crash or in the response to 9/11 than the competitive market makers on NASDAQ?
 - Compare profitability, spreads, actions around times of extreme events

2) Competition

- Is there an important trade-off between a centralized market with higher liquidity and a competitive market that may be more fragmented?
- Does a traditional “monopoly” specialist system work better in times of extreme market stress?

Is There Evidence of Less Competition/Liquidity vs. NASDAQ?

- NASDAQ's effective spread of 1.5 cents is 40 percent lower than the NYSE (Becker).
- NASDAQ executes 81 percent of trades at the quoted price v. 60 percent for the NYSE (Becker).

Changes in Rules/Institutions to Enhance Competition

- Allow for multiple market makers as at NASDAQ
- Recent changes to reduce burdens of the so-called “Trade-Through Rule” and Rule 390 directing trades to the floor
- Key is to achieve maximal competition while maintaining a liquid and orderly market

3) Governance Structure

- How to “get the incentives right” to balance the competing interests to make the appropriate trade-offs?
 - The board and its composition

Excess NYSE Board Size

- NYSE Board of Directors: 27
- NASDAQ Board of Directors: 20
- AMEX Board of Governors: 18
- Avg Forbes 500 Financial Firm Board
(Kroszner and Strahan 2003): 14
- Average NYSE-listed Firm Board
(Kroszner and Strahan 2001): 8-9

Problems with Current Structure

- Free Riders: With a large board, easier for any one director to avoid responsibility.
- Conflicts of interest: Which interests should be represented and how strongly?
 - Is a separated structure as at NASD-NASDAQ necessary for effective and credible self-policing?

Proposals for Restructuring

- Reduce board size and change composition (Reed): 17 directors
- 3 executives of major Wall Street firms
 - 1 specialist
 - 1 lessor
 - 1 floor broker
 - 3 publicly-listed company CEOs
 - 4 investing public
 - 3 public officials
 - 1 NYSE chairman

Current Structure vs. Proposal

<u>Category</u>	<u>Current</u>	<u>“Reed” Proposal</u>
Securities Industry	12 (44.4%)	6 (35.2%)
Public	12 (44.4%)	10 (58.8%)
NYSE Mgmt	3 (11.1%)	1 (5.9%)

CONCLUSIONS:

- Becker has done a fine job of documenting the relatively high returns for NYSE specialists
 - Important to understand the risk-reward trade-off to evaluate for policy purposes

CONCLUSIONS (continued):

- Steps toward enhancing competition are unlikely to harm the orderliness and liquidity of the markets
- Getting the incentives and balance of interests right with improved governance structure will help to ensure that appropriate trade-offs are made concerning the costs/benefits of the specialist system